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July 19, 2011

**BY HAND DELIVERY**

Ms. Cynthia T. Brown  
Chief, Section of Administration  
Office of Proceedings  
Surface Transportation Board  
395 E Street, S.W.  
Washington, DC 20423-0001

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Re: Arizona Electric Power Cooperative, Inc. v. BNSF Railway Company  
and Union Pacific Railroad Company, Docket No. 42113

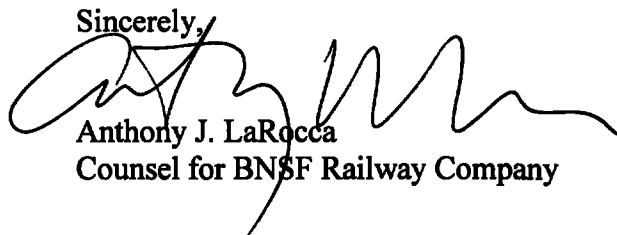
Dear Ms. Brown:

Enclosed for filing by Defendants BNSF Railway Company and Union Pacific Railroad Company in the above-referenced proceeding are an original and ten (10) copies of the Defendants' Response To The Revised Variable Cost Calculations Of Complainant Arizona Electric Power Cooperative, Inc.

Also enclosed are three CDs containing electronic workpapers supporting this filing. The electronic workpapers are being filed under seal and should be treated as Highly Confidential pursuant to the protective order in this proceeding.

Please date stamp the extra copy of this filing and return it with our messenger.

Sincerely,



Anthony J. LaRocca  
Counsel for BNSF Railway Company

Enclosures

cc: Parties of Record

**BEFORE THE  
SURFACE TRANSPORTATION BOARD**

**STB Docket No. 42113**



**ARIZONA ELECTRIC POWER COOPERATIVE, INC.  
v.  
BNSF RAILWAY COMPANY AND UNION PACIFIC RAILROAD COMPANY**

**DEFENDANTS' RESPONSE TO THE REVISED VARIABLE COST CALCULATIONS  
OF COMPLAINANT ARIZONA ELECTRIC POWER COOPERATIVE, INC.**

Defendants BNSF Railway Company and Union Pacific Railroad Company hereby respond to the revised variable cost calculations filed by complainant Arizona Electric Power Company ("AEPCO") on July 5, 2011. Defendants' Response is supported by workpapers prepared by Michael Baranowski and Benton Fisher of FTI Consulting, Inc.

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**I. Introduction**

As explained below, the Board concluded in its June 27, 2011 decision that AEPCO's variable cost calculations for the carload and multi-car shipments handled by the stand-alone railroad ("SARR") failed to account for the efficient, low-cost characteristics of those movements over the portions of the through movements replicated by the SARR.<sup>1</sup> Nevertheless, for the SARR's intermodal traffic, AEPCO's July 5, 2011 revised variable cost calculations *increase*, not *decrease*, the costs of that traffic. AEPCO erred by calculating the variable costs

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<sup>1</sup> In their reply evidence and argument, Defendants' addressed the issue identified by the Board by using the SARR's URCS variable costs in the Maximum Markup Methodology ("MMM") calculations. *See* Joint Reply Evidence of Defendants BNSF Railway Company and Union Pacific Railroad Company, at III.H-8-17 (filed May 7, 2010) ("Defendants' Reply Evidence"). Defendants continue to believe their approach is correct and reserve their rights to pursue their position on appeal. However, for purposes of responding to the Board's June 27, 2011 decision, defendants address the issues that arise under the logic of the Board's approach as set out in the June 27, 2011 decision.

for the SARR's non-coal traffic using the empty return ratio applicable to unit train traffic rather than the empty return ratio for the applicable traffic group. Defendants have corrected this error.

There are two additional flaws in AEPCO's revised cost calculations. First, AEPCO correctly used the Board's 2009 URCS to cost carload and multi-car shipments, but it failed to correct the variable cost calculations for the remaining trainload traffic, which AEPCO had previously costed using a flawed preliminary version of the 2009 URCS. To ensure a consistent basis for costing all SARR traffic, defendants have revised the variable costs of the entire traffic group using the Board's 2009 URCS. Second, AEPCO improperly calculated the variable costs of the issue traffic using mileage assumptions that are inconsistent with AEPCO's SAC assumptions. Defendants have corrected this flaw in the issue traffic variable costs.

In addition, the Board's June 27, 2011 decision focused on the impact of AEPCO's variable cost calculations on application of the MMM methodology. However, defendants' variable costs for the transportation provided over SARR segments are also used in the Average Total Cost ("ATC") calculations. In ATC, defendants' variable costs for the transportation of SARR traffic over the portions of the through movement replicated by the SARR are used to determine the amount of revenue that should be allocated to the SARR. In MMM, defendants' variable costs for the transportation of SARR traffic over the portions of the through movement replicated by the SARR are used to allocate responsibility for SAC costs among SARR shippers and to determine the maximum reasonable MMM R/VC ratio. If MMM is to be calculated using defendants' variable costs, the same variable cost assumptions should be used in both sets of calculations. Defendants therefore revised AEPCO's ATC-based revenue allocation using the new variable cost calculations.

**II. AEPCO's Revised Cost Calculations Overstate The Variable Costs Of The SARR's Intermodal Traffic Because AEPCO Applied The Wrong Empty Return Ratios.**

In its June 27, 2011 decision in this case, the Board ordered AEPCO "to submit revised variable costs calculations, reflecting actual operating characteristics of the movements on the SARR, for the traffic group submitted on rebuttal." June 27, 2011 Decision at 2. The Board explained that "most of AEPCO's traffic group moves in trainload service, but most of the variable costs calculated for that group are costed assuming it is moved in carload and multi-car service." *Id.* The Board's concern applied only to the SARR's non-coal traffic. AEPCO properly costed the SARR's coal traffic as trainload traffic, but it determined the costs of the SARR's non-coal traffic, including intermodal traffic, assuming it had the characteristics of carload or multi-car shipments. However, both coal traffic and non-coal traffic are handled by defendants over the portions of defendants' rail networks replicated by the SARR essentially as trainload service. The Board's URCS cost model recognizes that trainload service has substantially lower variable costs than carload and multi-car service. The Board was concerned that by costing non-coal traffic as carload or multi-car shipments, the variable costs of that service would be overstated.

The Board's concern was justified. For the carload and multi-car shipments included in the SARR traffic group as cross-over traffic, AEPCO assumed that the SARR would handle the traffic over the most efficient, least cost portion of the through movement. The significant costs associated with gathering, classifying, switching and delivering cars, among other costs typically incurred for carload and multi-car shipments, are not incurred over the portion of the through movement replicated by the SARR. Therefore, the variable costs of the carload and multi-car shipments over the on-SARR portion of the movement are considerably less than the variable costs of that traffic on the off-SARR portions of the through movement. AEPCO's cost

calculations did not reflect the substantial cost differences between the on-SARR and off-SARR portions of the through movement arising from the different movement characteristics on the two portions of the through movement.

The Board clearly assumed that by treating the carload and multi-car shipments as trainload shipments for purposes of estimating the costs of that traffic over the portion of the through movement replicated by the SARR, the costs of those movements would be reduced. The lower costs would reflect the fact that very few costs other than line-haul costs are incurred over the portion of the through movement replicated by the SARR. In turn, by reducing the costs of the carload and multi-car shipments, the Board's MMM model would reduce the amount of SAC cost for which the carload and multi-car shipments are responsible and increase the responsibility for SAC costs allocated to coal traffic, including the issue traffic.

The revised variable costs submitted by AEPCO for the SARR's intermodal traffic, which is a major part of the SARR traffic group, flip the Board's expectation on its head. For intermodal traffic, AEPCO actually *increased* the variable costs of the traffic. The flaw in AEPCO's revised costs is that AEPCO applied the empty return ratio applicable to unit train traffic to intermodal traffic. URCS applies a default assumption that unit trains have an empty car for every loaded car. However, intermodal trains have relatively few empty cars, which is reflected in the very different empty return ratio that URCS applies to intermodal traffic. Applying the empty return ratio for unit trains to intermodal traffic therefore dramatically overstated the variable costs of the intermodal traffic. AEPCO also improperly used the empty return ratio applicable to unit trains in revising the costs of the other non-coal shipments, although the impact was not as great as with the SARR's intermodal traffic. Defendants have corrected this error by costing the SARR's non-coal traffic using defendants' empty return ratios

for the applicable traffic group. The results are set out in the electronic workpapers accompanying this filing.<sup>2</sup>

**III. The Board's 2009 URCS Should Be Used To Determine Variable Costs For The Entire Traffic Group.**

AEPCO filed its rebuttal evidence in this case before the Board issued the defendants' 2009 URCS. Instead of using the Board's 2008 URCS with appropriate indices to determine the variable costs of the SARR traffic, AEPCO based its rebuttal evidence on a 2009 URCS that AEPCO prepared for the litigation. Since AEPCO submitted that new variable cost evidence on rebuttal, defendants did not have an opportunity to address AEPCO's preliminary 2009 URCS in a responsive filing. However, defendants pointed out in their final brief that the 2009 URCS prepared by AEPCO was flawed. *See* Final Brief of Defendants BNSF Railway Company and Union Pacific Railroad Company, at 19-20 (filed July 29, 2010).

In preparing the revised variable costs of the non-coal SARR traffic for AEPCO's July 5, 2011 filing, AEPCO properly used the 2009 URCS issued by the Board. However, AEPCO failed to restate the variable costs of the SARR's coal traffic using the Board's 2009 URCS. As a result, the variable costs of the SARR's coal and non-coal traffic have been prepared with different and inconsistent URCS cost assumptions. Defendants have restated the variable costs of the SARR's coal traffic using the Board's 2009 URCS.

**IV. The Issue Traffic Variable Costs Should Be Calculated Using The SARR Route.**

In their reply evidence, defendants noted that if the MMM methodology needed to be used to calculate a maximum reasonable rate, the variable costs of the issue traffic should be determined using the route miles associated with the rerouted route of movement of the issue

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<sup>2</sup> *See* BNSF\_GF\_MMM\_VC RR Reply.xlsx, BNSF\_IM\_MMM\_VC RR Reply.xlsx, UP\_IM\_MMM\_VC RR Reply.xlsx.

traffic. *See* Defendants' Reply Evidence, at III.H-17. It would be necessary to use the rerouted route miles rather than the real world route miles because the objective of MMM is to allocate SAC costs to the SARR traffic based on the relative share of SARR service received by each movement, as measured by the variable costs of the movement on the lines replicated by the SARR. Since the issue traffic is assumed to move over a longer route on the SARR than the route it moves on in the real world, the share of service that the issue traffic receives from the SARR should be determined based on the longer route assumed to occur on the SARR.

In AEPCO's July 5, 2011 filing, AEPCO calculated the issue traffic variable costs using the real world route miles. Defendants have corrected the issue traffic variable costs based on the SARR miles.<sup>3</sup>

**V. The Modified Variable Costs Should Also Be Used in the ATC Calculations.**

The Board's June 11, 2011 decision discussed the need to revise AEPCO's calculation of the defendants' variable costs for the transportation provided over SARR segments for purposes of applying the MMM methodology. However, the defendants' variable costs are also used in ATC to determine SARR revenues. Therefore, to maintain consistency, AEPCO's ATC-based calculation of SARR revenues should also be revised.

In their reply evidence, defendants urged the Board to use different cost assumptions in applying ATC and MMM in the SAC analysis. Specifically, defendants acknowledged that defendants' URCS variable costs are used in the ATC calculations, but defendants urged the

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<sup>3</sup> If the Board found it necessary to establish a maximum reasonable R/VC ratio using MMM, it would be necessary to create a linking factor in determining the maximum reasonable R/VC ratio for the issue traffic to ensure that the issue traffic generated sufficient revenues over the shorter, real world route. Also, as noted in defendants' reply evidence, it would be necessary to carry out a cross-subsidy analysis of the Vaughn-El Paso SARR segment. *See* Defendants' Reply Evidence, at III.H-16-17.

Board to use the *SARR*'s URCS variable costs, rather than the defendants' URCS variable costs, in the MMM calculations to allocate responsibility for the *SARR*'s costs to the *SARR*'s traffic. In the June 27, 2011 decision, the Board stated that it had rejected defendants' argument that the *SARR*'s URCS costs should be used in the MMM calculations. The Board stated that the defendants' proposed approach was not consistent with *Major Issues in Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1) (served Oct. 30, 2006), "which stated that the Board would use defendants' own costs for this purpose." June 27, 2011 Decision at 2.

Having decided that MMM must be applied using *defendants'* costs for the portion of the movement replicated by the *SARR*, and having decided that for purposes of MMM those costs should be calculated for carload and multi-car shipments using cost assumptions that reflect the highly efficient, trainload cost characteristics of that traffic while moving over the *SARR* portion of the through movement, the ATC revenue allocation calculations must also be changed to reflect the revised cost assumptions.<sup>4</sup>

The defendants' variable costs are a critical component of the ATC methodology. Basically, the ATC calculations use the defendant's variable costs for the on-*SARR* and off-*SARR* portions of a cross-over movement to allocate through revenue to the on-*SARR* and off-*SARR* portions of the movement based on the relative average total on-*SARR* and off-*SARR* costs. Under the Board's approach, MMM then uses the defendants' variable costs in the calculations to allocate responsibility for the *SARR*'s costs among the specific movements handled by the *SARR* and thereby to determine the maximum R/VC that can be charged to the *SARR* shippers. As a matter of logical consistency, the same adjustments that are made to defendants' variable costs for the transportation provided over the *SARR* for purposes of

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<sup>4</sup> See note 1, *supra*.



applying the MMM methodology must also be made to cross-over traffic for purposes of applying the ATC methodology. Indeed, the Board has used the same variable cost assumptions in the ATC and MMM calculations in the SAC cases that have been decided after the Board adopted ATC and MMM.

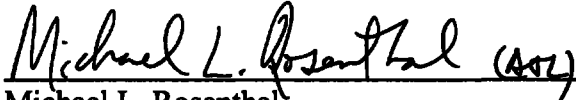
Defendants have therefore revised AEPCO's previously submitted ATC calculations to reflect the new variable cost assumptions for the SARR's non-coal, cross-over traffic. To determine SARR revenues using the revised variable cost calculations, defendants determined the on-SARR variable costs as described above, using the proper empty return ratio for each traffic group. Defendants increased the off-SARR variable costs to ensure that the sum of on-SARR and off-SARR variable costs equaled the total variable costs for the movement as calculated by URCS. Defendants used the resulting calculations in the Board's current modified form of ATC to determine SARR revenues.<sup>5</sup> The SARR's revised revenues are set out in the electronic workpapers accompanying this filing.<sup>6</sup>

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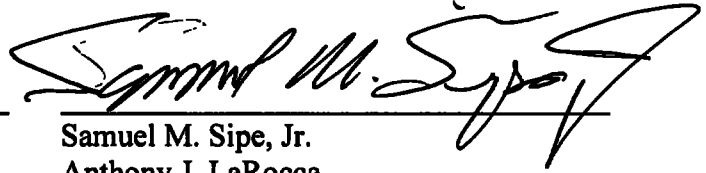
<sup>5</sup> BNSF explained in its October 18, 2010 Motion Regarding the Board's Consideration of the Average Total Cost Revenue Allocation Methodology, that a dispute over the Board's application of its ATC methodology is pending in *Western Fuels Ass'n & Basin Elec. Power Coop V. BNSF Ry*, STB Docket No. 42088 ("*WFA/Basin*"). As BNSF explained in its Motion, the Board should refrain from ruling on the merits of its current modified ATC methodology in this proceeding and allow that issue to be decided in *WFA/Basin* based on a record that has been fully developed in that case. Defendants present their ATC calculations here using the Board's modified ATC methodology, consistent with the approach used by AEPCO in its evidence in this case, but reserve their objection to modified ATC pending the Board's decision in *WFA/Basin*.

<sup>6</sup> See Exhibit III-A-3 ATC Comparison.xlsx.

Respectfully submitted,



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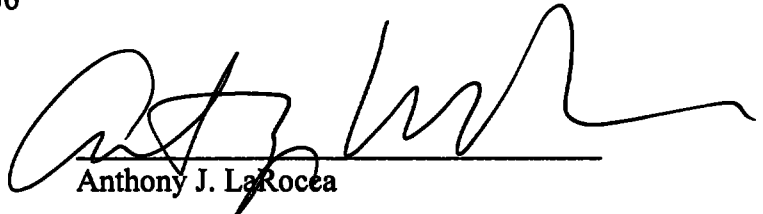
**ATTORNEYS FOR  
BNSF RAILWAY COMPANY**

July 19, 2011

## **CERTIFICATE OF SERVICE**

I hereby certify that on this 19<sup>th</sup> day of July, 2011, I caused a copy of the foregoing Defendants' Response to the Revised Variable Cost Calculations of Complainant Arizona Electric Power Cooperative, Inc. to be served on the following Parties of Record by hand delivery:

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